

Decision **DRAFT DECISION OF ALJ BUSHEY** (Mailed 6/10/2003)**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

Application of Point Arena Water Works, Inc. for an order authorizing a rate increase in rates subject to refund producing additional annual revenues of \$70,137 or 56.9% for the test year 2002.

Application 02-11-057  
(Filed November 25, 2002)

**INTERIM OPINION EXCLUDING 1995 TAX REFUND  
FROM TEST YEAR 2002 GENERAL RATE CASE****Summary**

This decision holds that the scope of this test year 2002 general rate case proceeding will not include income tax refunds received by Point Arena Water Works (PAWW) over a several-year period ending in 1995.

**Background**

In Resolution W-4356, October 24, 2002, the Commission granted PAWW a \$70,137 or 56.9% rate increase, subject to refund. About a year earlier, the Commission had also granted PAWW a \$47,677 or 62.3% rate increase, also subject to refund, based on a finding that such an increase was necessary to provide sufficient funds to meet PAWW's cash operating expenses with no depreciation or rate of return on rate base. The Commission noted that PAWW's last rate case was in 1991, and that PAWW operated at a loss of \$56,687 in 2000. As part of its review leading up to Res. W-4356, the staff conducted two public

meetings in Point Arena and prepared an extensive staff report with accompanying audit of the utility's 2000 books of account.

The City of Point Arena (City) objected to the rate increases requested by PAWW and disagreed with staff's review. At the staff's recommendation, the Commission converted this advice letter rate case to a formal proceeding in Resolution W-4356.

PAWW, staff, and the City also differed regarding the proper ratemaking treatment of an income tax refund to PAWW from the early 1990s. The staff auditor concluded from PAWW's records, that (1) the tax refund had been obtained by PAWW at its own expense, and (2) the money had been used to meet operating and maintenance expenses that utility revenue failed to cover. Accordingly, the auditor recommended the tax refund not be used to lower prospective rates. The City disagreed. In Res. W-4356, the Commission included this issue in the formal proceeding.

On March 20, 2003, the assigned Administrative Law Judge (ALJ) convened a prehearing conference (PHC). The tax refund was among the matters discussed at the PHC, and the ALJ set a briefing schedule regarding the refund. The ALJ also set a procedural schedule for the remainder of this proceeding. As noted above, the rate increase proposals at issue here have been through an extensive informal review process with our staff, including an audit and a staff report. PAWW and our staff indicated at the PHC that they would rely extensively on these previously prepared analyses to make the required showing.

As set out in Res. W-4356, the tax refund issue must also be addressed in this proceeding. The tax refund has great significance for revenue requirement, with the potential of completely offsetting current rate base. Consequently,

resolution of this issue is key to the scope of the subsequent portions of this proceeding. The parties have filed extensive opening and reply briefs, with accompanying documentation.

In its initial brief, PAWW provided documents (including copies of cancelled checks) showing that the net state and federal tax refund was \$184,954 and that it had been received by 1995. PAWW also showed that customers did not pay any of the costs of obtaining this refund. PAWW explained that in 1993 AT&T Communications, Inc. (AT&T) agreed to fund a new water main that would enable PAWW to provide fire protection to Point Arena City Hall and High School. AT&T entered into such an agreement to promote good will with the community due to a series of construction failures, with resulting environmental degradation, when crossing streams with its fiber optic cable system. AT&T paid \$660,236.79 to PAWW for the costs of the water main. At the time, AT&T and PAWW believed that federal tax law would characterize such a payment as a contribution in aid of construction, and that the payment would be taxable income to PAWW. Consequently, AT&T and PAWW agreed that AT&T would pay to PAWW the amount of the expected tax in addition to actual construction costs. PAWW then remitted the tax amount to the state and federal taxing authorities. PAWW subsequently came to believe that changes in the tax laws had resulted in this type of construction payment being no longer considered income. PAWW decided to seek a refund, and AT&T declined to participate in the effort or to share in any amounts recovered. PAWW successfully obtained state and federal refunds.

In its initial brief, the City contended that AT&T's total payment, including the amount for taxes, to PAWW should be included in PAWW's contributions in aid of construction account. For ratemaking purposes, contributions in aid of

construction are an offset to ratebase so the City's proposal would have the effect of reducing ratebase by the amount of refund. The City calculated the total refund to be about \$519,000. The City also argued that the misuse and disappearance of this amount from PAWW's accounts has a significant and continuing impact on the financial capability of the company to provide safe and efficient service.

In its reply brief, PAWW vigorously contested the City's calculation of the amount at issue and referred to the documents attached to its opening brief. PAWW also contended that the City's proposal to use the tax refunds as an offset to rate base would effectively deny PAWW an opportunity to earn a rate of return and would violate the rule against retroactive ratemaking.

The City, in its reply brief, stated that PAWW had illegally removed the tax refund amount from the contributions in aid of construction account and paid it to the shareholder and affiliated businesses, and that restoring it to the account would correct this error.

## **Discussion**

Pursuant to Pub. Util. Code § 451, all rates charged by a public utility must be just and reasonable. The Commission has determined that such rates must be based on the reasonable cost of providing service to customers. Specifically, the Commission uses projections of future costs - a "future test year" - to evaluate whether the revenue to be collected from customers under proposed rates would cover the utility's costs.

For large water utilities, the Commission has set a three-year schedule for each utility to present a general rate case to the Commission. In this way, the Commission can monitor revenue and cost levels to ensure that the utility is

neither over nor under earning. (See Re Schedule for Processing Rate Case Applications by Water Utilities, 37 CPUC2d 175 (D.90-08-045).)

For small water utilities, such as PAWW, the cost of presenting a formal rate case to the Commission is a significant expense. The Commission, therefore, has established a simplified procedure for rate case review, which enables small water utilities to obtain rate review and any needed modifications more economically. The Commission has not imposed a specific time schedule on small water utilities to file general rate cases. Despite the flexibility the Commission has allowed small water utilities, the Commission has not wavered from its commitment to small water utilities charging cost-based rates.

The evidence described in Res. W- 4356 shows that PAWW had allowed its rates to diverge substantially from its costs. In 2000, our auditors found that such divergence resulted in operating expenses exceeding operating revenues, which justified an immediate 62% rate increase just to meet cash operating expenses, with no depreciation or return on rate base. These facts demonstrate that PAWW's 2000 rates bore little relation to PAWW's 2000 costs. This failure to synchronize costs and rates is at odds with our fundamental commitment to cost-based rates.

PAWW sought to correct this imbalance in 2002 with its request to triple its rates. Although the Commission allowed only a bit more than doubling the rates, customers were understandably distressed by this sudden and substantial increase. Such an outcome, however, is directly attributable to PAWW's decisions not to seek rate review for over a decade.

Another likely outcome of postponing rate review for so long is that in the intervening decade PAWW would make management decisions that are inconsistent with Commission policy. PAWW's use of the income tax refunds

for operating and maintenance expenses was such a decision. When a public utility receives substantial and unexpected revenue, the Commission's strong preference is to evaluate prospectively options for allocating the revenue. Here, however, PAWW's long absence from Commission review has precluded prospective allocation.

Instead, the City has presented us with a sound argument for one possible allocation methodology, namely, treating the tax refund as a contribution in aid of construction. The California Constitution and the Public Utilities Code grant us sufficient ratemaking authority over PAWW to allow us to implement this option, and others, if we determined that such an outcome was supported by the facts. For the reasons set out below, however, we decline to do so.

First, PAWW's shareholders have incurred substantial out-of-pocket losses in the last several years. Our auditor documented a net operating loss of \$56,687 in 2000, and the recently filed 2002 annual report showed a \$28,636 loss, despite the rate increase authorized in October 2002. These documented losses of nearly \$90,000 in just two years suggest that over the last several years PAWW's losses have exceeded the net tax refund. Moreover, we are compelled to note the practical difficulties inherent in allocating funds that are no longer available. While the Commission can and does impute improperly used funds regardless of the actual availability of the funds, such ratemaking fictions are of little use to a small system, such as PAWW's, which requires actual cash to meet expenses. Accordingly, persuasive facts must be presented to justify setting aside these practical issues. In today's decision, we find that such facts are not present.

Second, PAWW's customers did not pay any of the costs associated with obtaining the refund, and yet benefited from the refund. PAWW management, with the assistance of counsel, sought and obtained the refund at no cost to

customers. Moreover, our auditor found that PAWW used the tax refund for operating and maintenance expenses, which kept customer rates lower than a revenue requirement analysis would have supported. The magnitude of the rate increase authorized in Res. W-4356, more than doubling rates, shows that customer revenue has not been adequate to meet costs. Thus, the lengthy rate case hiatus, which enabled this issue to remain dormant for so long, has benefited customers in the form of lower rates and has resulted in substantial losses for shareholders.

Third, the City's proposed treatment of the tax refund as a contribution in aid of construction is but one of many allocation methodologies that we might use to address this issue. In its briefs, the City cites extensively to the Uniform System of Accounts for the proposition that the tax refund should be returned to the contributions in aid of construction account and used as a deduction to rate base. Simply crediting the amount to that account, however, does not resolve the ratemaking question. It is a well-settled proposition that accounting rules do not control ratemaking. (See, e.g., Decision No. 42068, (September 21, 1948) 48 CPUC 253, 257.)

The Commission has previously changed accounting and ratemaking treatment after the fact, rejecting assertions that to do so would violate the rule against retroactive ratemaking. In Re California Water Service Company, (1994) 56 CPUC2d 4 (D.94-09-032), the Commission ordered Cal Water to change its accounting and ratemaking for sale proceeds from 26 real estate parcels from giving all proceeds to shareholders to dividing the proceeds 50/50 between

shareholders and ratepayers.<sup>1</sup> The Commission found that: “[Its] ratemaking authority is not constrained by the Uniform System of Accounts” and that such changes to a utility’s accounting and ratemaking treatment do not constitute retroactive ratemaking. (Id. at 18.)

Here, as in the Cal Water decision, the Commission has the discretion to order changes in the accounting and ratemaking for this capital account. The Commission reached its decision in Cal Water by “weighing the equities and consideration of the ongoing needs of the utility.” Consideration of similar factors in this case leads to today’s decision declining to change PAWW’s accounting and ratemaking treatment. Also as noted in Cal Water, we direct PAWW in the future to comply fully with the Uniform System of Accounts and to seek staff guidance when needed.

If the Commission had been presented with this issue in a timely manner, the Commission would have used its broad discretion in an orderly manner to allocate this extraordinary revenue pursuant to a wide range of potential allocation methodologies. However, retrospective allocation of the funds after the passage of many years adds substantial complexities including the potential for significant accounting adjustments to PAWW’s books. While such adjustments are within the Commission’s authority, such extraordinary actions must be taken in response to compelling circumstances, which we do not find here.

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<sup>1</sup> The Commission concluded that the changes in accounting and ratemaking would not be retroactive ratemaking because the changes would not result in any adjustment to previously collected rates.

In sum, we are quite displeased with the factual circumstances surrounding the tax refunds and this long overdue rate case. After careful consideration of the facts and argument presented by the City, we are not persuaded, however, that these circumstances have resulted in or will result in unjust or unreasonable rates, or that the public interest otherwise justifies consideration of this nearly decade-old issue. Therefore, based on the unique facts of this case, we find that the issue of the income tax refunds should be excluded from the scope of this proceeding.

To ensure that similar issues do not arise in the future, we will order PAWW to file an informal general rate case no less frequently than once every three calendar years.

### **Comments on Draft Decision**

The draft decision of the ALJ in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(g)(1) and Rule 77.7 of the Rules of Practice and Procedure. Comments were filed on \_\_\_\_\_, and reply comments were filed on \_\_\_\_\_.

### **Assignment of Proceeding**

Carl W. Wood is the Assigned Commissioner and Maribeth A. Bushey is the assigned Administrative Law Judge in this proceeding.

### **Findings of Fact**

1. PAWW's last general rate case was in 1991.
2. Since some time after 1991, PAWW's rates have failed to generate sufficient revenue to meet reasonable expenses.
3. PAWW received extraordinary revenue in the form of income tax refunds over a several-year period ending in 1995.

4. PAWW did not seek Commission direction as to the disposition of the income tax refunds.

5. The staff auditor concluded that the tax refunds had been obtained by PAWW at its own expense, and the money had been used to meet operation and maintenance expenses that utility revenue failed to cover.

**Conclusions of Law**

1. The Commission's ratemaking authority is sufficient to order consideration of the tax refunds in this proceeding.

2. The Commission should exercise its ratemaking discretion to decline to consider the income tax refunds in this proceeding due to the losses incurred by PAWW and complexities caused by the passage of time.

3. PAWW should file an informal general rate case no less frequently than once every three calendar years.

**INTERIM ORDER**

**IT IS ORDERED** that the scope of this proceeding shall not include income tax refunds received by Point Arena Water Works (PAWW) over a several year period ending in 1995 and that PAWW shall file an informal general rate cases no less frequently than once every three calendar years.

This order is effective today.

Dated \_\_\_\_\_, at San Francisco, California.